RBC Global Asset Management
PH&N Institutional

Emerging market equities: Ready to re-emerge?

The trend among Canadian institutional investors in recent years has been for global equities to occupy an increasingly large portion of the total equity allocation, while allocations to Canadian and emerging market equities (EME) have shrunk. Reduced Canadian exposure can be partially explained by diversification, as Canadian equity holdings had been structurally high given Canada's small relative size among developed market (DM) peers. The lower level of institutional interest in EM equities, however, is rooted in performance: EM equities have underperformed relative to their DM counterparts for over a decade, which represents the longest downcycle since the asset class was formally established in the late 1980s.

The purpose of this paper is to argue that the outlook for EM equities from today's starting point is attractive relative to their global DM counterparts. In a recently published sister paper, we made a similar argument for allocations to Canadian equities, though for different reasons. We believe there is a strong argument for institutional investors to consider increasing allocations to both EM and Canadian equities; in this paper, we will focus on the case for EM equities.

What EME looks like in 2024

Emerging market countries have continued to develop and evolve, despite the relative weakness of their equity markets in recent years. Today, EM has grown to represent more than half of global GDP and perhaps more importantly, accounts for two-thirds of global GDP growth, making emerging markets too large to ignore.

EME cycles: Where are we now?

Emerging market equities have historically gone through long cycles of relative under performance or out performance vs developed markets. As shown in Figure 1 on the following page, EM equities have been through a prolonged period of relative weakness since 2010.

The primary reasons for this nearly 15-year period of malaise include slowing growth in China (the country with the dominant weight in the MSCI Emerging Markets Index) a surging U.S. dollar, and a narrowing earnings growth differential between EM and DM companies. While it's difficult to time when these cycles will turn, it is notable that many of the factors that have held EM back over the past decade look set to reverse. The following sections will address a number of these factors in more detail.

Figure 1: EM vs DM equities' relative performance since 1989

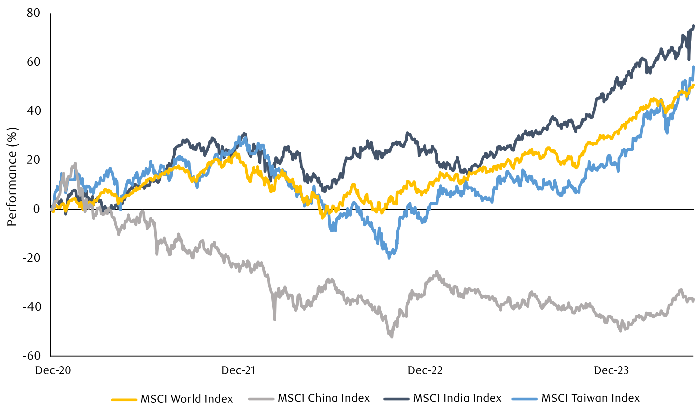
Source: RBC GAM, MSCI, Bloomberg, as at March 31, 2024.

China is becoming less relevant...

One of the biggest questions surrounding the prospects of EM equities is whether the MSCI EM Index can outperform if its largest single component remains weak.

China outperformed the world during the start of the COVID pandemic but has been a drag on relative performance since 2021. It's notable that the two largest and fastest-growing markets in the MSCI EM Index outside of China — India and Taiwan — have both outperformed the MSCI World Index over this time period.

Figure 2: Equity markets performance – World, China, India, and Taiwan



Source: RBC GAM, MSCI, as at March 31, 2024. All indicies in CAD.

The result has been a precipitous fall in China's overall weight within the MSCI EM Index, from over 40% in late 2020 to 25% today.[1] We believe that China is undergoing a structural decline largely due to geopolitical concerns and a less favourable demographic outlook. China's trade with the West is also likely to continue declining as western companies expand their "China Plus One" approach – a strategy of diversifying supply chains and manufacturing activities in an effort to rely less on China.

While investor sentiment towards China is overwhelmingly negative, we believe there is a path for China to return to sustainable growth, with increased domestic consumption replacing exports as the primary driver. It should also be noted that China's GDP is still growing at a rate of over 5% year-over-year. And despite expected declines in China's trade with the West, its trade with the global south is growing and will likely continue to do so, supported by China's strategic "Belt and Road" global infrastructure development initiative.

The Chinese equity market continues to face key headwinds over the near term, however, which will likely continue to pressure China's weight and influence within EME over the coming years.

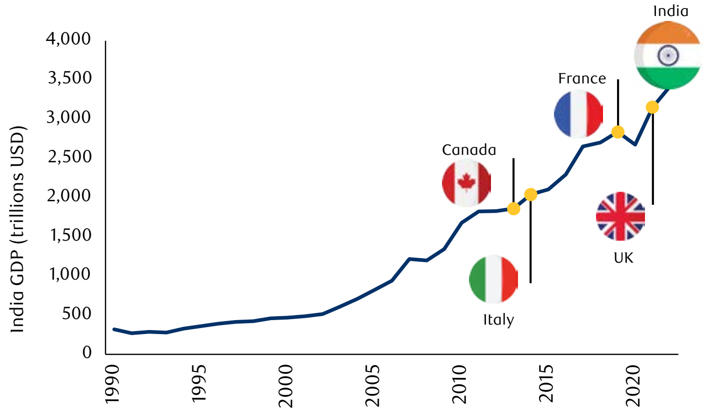
...while India looks set to lead

One country that has stood out for different reasons is India, which has seen its weight in the MSCI EM Index double since the start of 2020.[2] India now stands at a similar juncture to where China was at the start of the 2000s, with reforms leading to strong economic growth and industrialization, and potentially lifting millions out of poverty and into the consumption class.

We have long been constructive on India, valuing its strong management teams, established franchises, attractive demographics, and relatively high-functioning democratic institutions. In recent years, our conviction has been strengthened by the comprehensive economic and anti-corruption reforms that have been undertaken by the government. These positive developments have been well received by global businesses and investors alike, as evidenced by the inflow of major global companies that are now setting up meaningful operations in India, largely at the expense of China.

Figure 3 illustrates the impact of these developments, with India's economy now having surpassed almost all of the G7 – including its former colonial ruler, the U.K. – and on track to become the world's third largest (behind the U.S. and China) by 2031.

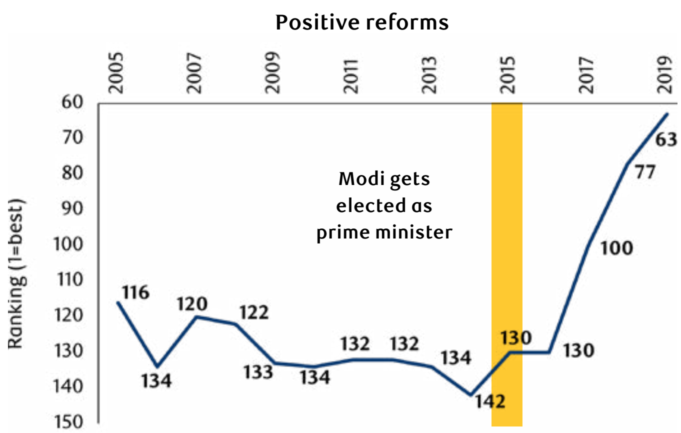
Figure 3: India's rising GDP relative to other G7 nations



Source: RBC GAM, CEIC, Morgan Stanley Research Forecasts, October 2022.

The economic reforms enacted thus far have focused on reducing red tape, bureaucratic corruption, and other inefficiencies, which have historically been among the biggest barriers to India's ability to attract foreign investment. India's ranking on the IMF's "Ease of Doing Business Index" has risen dramatically as a result, and the country has welcomed a surge of American and other western companies setting up operations in India.

Figure 4: India's ranking on the IMF's Ease of Doing Business Index surges



Source: RBC GAM, The World Bank. UN Population Division World Population Prospects 2022, World Bank Doing Business database (2005-2019) as at May 2024. There is no assurance that any of the trends depicted or described herein will continue.

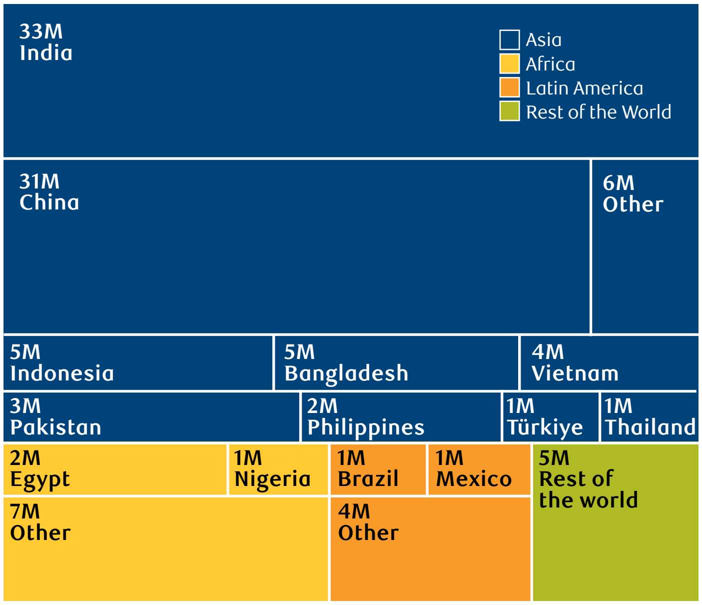
[1] As of March 31, 2024.
[2] India comprised 8.6% of the MSCI Emerging Markets Index as of January 1, 2020, and 17.70% as of March 31, 2024. Source: MSCI, RBC GAM.

We believe that the coming decade will belong to India, and that given its sizable and growing weight in the MSCI EM Index, it could be the driver for a new cycle of EM outperformance in the same way that China led the way during the last upcycle.

A rapidly growing consumer class

From a Canadian investor standpoint, emerging markets offer access to both growing markets and companies, as well as diversification from developed market equity exposure. It's estimated that 2024 will see record growth in the global middle or "consumer class," with approximately 113 million people expected to enter this category over the course of the year, and nearly all of them from EM nations, led by India and China.[3]

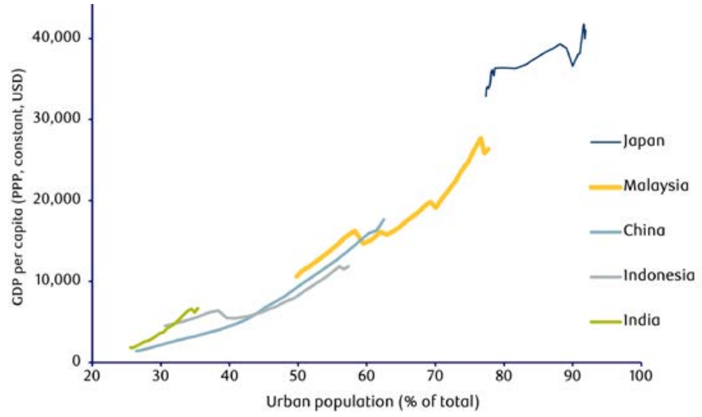
Figure 5: Consumer class growth in 2024



World Data Lab defines the customer class as those spending at least $12 per day (measured in 2017 purhasing power parity, or PPP prices). Source: World Data Pro.

An important driver of this growth is urbanization. Figure 6 shows the relationship between a growing urban population and GDP-per-capita growth for selected countries over a 30-year period. For example, we can see how China's GDP-per-capita has increased exponentially over the last 30 years as its urbanization rate has climbed. It is worth noting that other large EM countries, such as Indonesia and especially India, are still early in this development and there is strong potential for higher urbanization rates to drive long-term economic growth.

Figure 6: Progression of urbanization vs per capita economic output, 1990-2021



Source: RBC GAM, CLSA, World Bank Development Indicators, September 2023.

U.S. dollar headwind may be easing

Of all the factors that have weighed on emerging markets in recent years, the strength of the U.S. dollar has been among the heaviest. A strong U.S. dollar creates several headwinds for EM companies (especially those focused on domestic consumers), while severely limiting the ability of EM governments to support capital-intensive investments in areas such as infrastructure, health care, and education.

There are signs, however, that the current period of U.S. dollar strength may be ready to turn. As illustrated in Figure 7, the USD also trades in long, multi-year cycles. Unsurprisingly, these cycles tend to coincide strongly with the relative performance of U.S. (and by extension, global) equities relative to EM.

Figure 7: U.S. Federal Reserve (Fed) trade-weighted real broad dollar index

Source: RBC GAM, U.S. Federal Reserve, as at March 31, 2024.

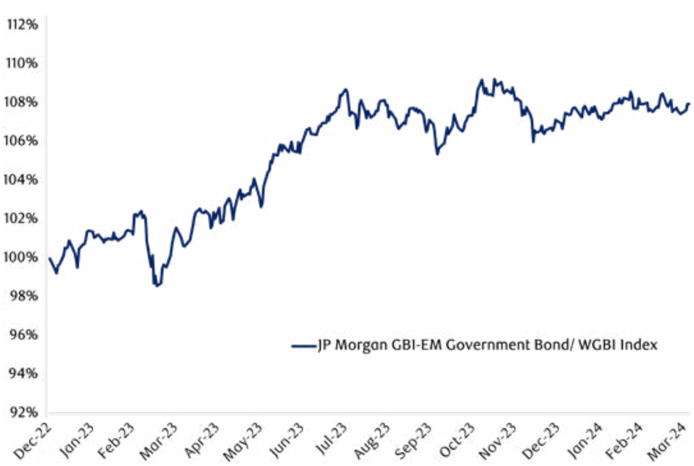
[3] "113 Million People Will Join the Global Middle Class in 2024," Visual Capitalist, October 2023.

A number of indicators and factors are pointing to a change in U.S. dollar strength, from relative value measures (e.g., purchasing power parity), to fundamental metrics (e.g., increasingly large U.S. fiscal imbalance coupled with a growing account deficit).

In contrast, EM countries have been much more conservative in their approach to both fiscal and monetary expansion, due in large part to the constraints imposed by a strong U.S. dollar. EM countries also showed more fiscal constraint during the COVID-19 pandemic and many large EM countries, including India and Brazil, have enacted meaningful economic reforms that are starting to pay dividends within their respective economies.

While this divergence in favour of EM isn't yet being reflected in currency markets, it appears that the fixed income markets have noticed. EM local government debt outperformed DM local government debt over 2023, which is a clear indication that bond investors have confidence in the overall fiscal and monetary health of emerging markets.

Figure 8: Performance of EM local government debt vs DM local government debt (USD)



Source: RBC GAM, Bloomberg, as of March 31, 2024.

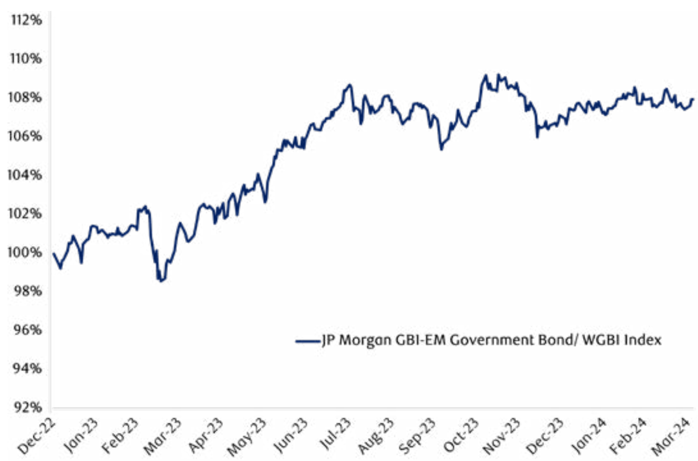
Other fundamental metrics tilting in favour of EME

Emerging markets have long held a fundamental edge over developed markets in both demographics and economic growth, but over the past decade, this hasn't been enough to overcome other factors that have weighed against it. Now, it appears that some of those factors may be set to reverse.

Interest rates and monetary policy

On the monetary side, the central banks of many EM countries were fast to respond to rising inflation in recent years and started tightening monetary conditions before many developed market central banks. We are now entering into an unprecedented situation, where EM nominal policy interest rates are converging with DM rates and are poised to drop below them for the first time, as illustrated in Figure 9. A key difference for EM policy going forward will be the ability to reduce interest rates ahead of DM due to high real interest rates in many EM countries. We've already started to see interest rate cuts in several Latin American countries, and we would expect more emerging market countries to follow suit in coming months.

Figure 9: EM vs DM nominal policy rates

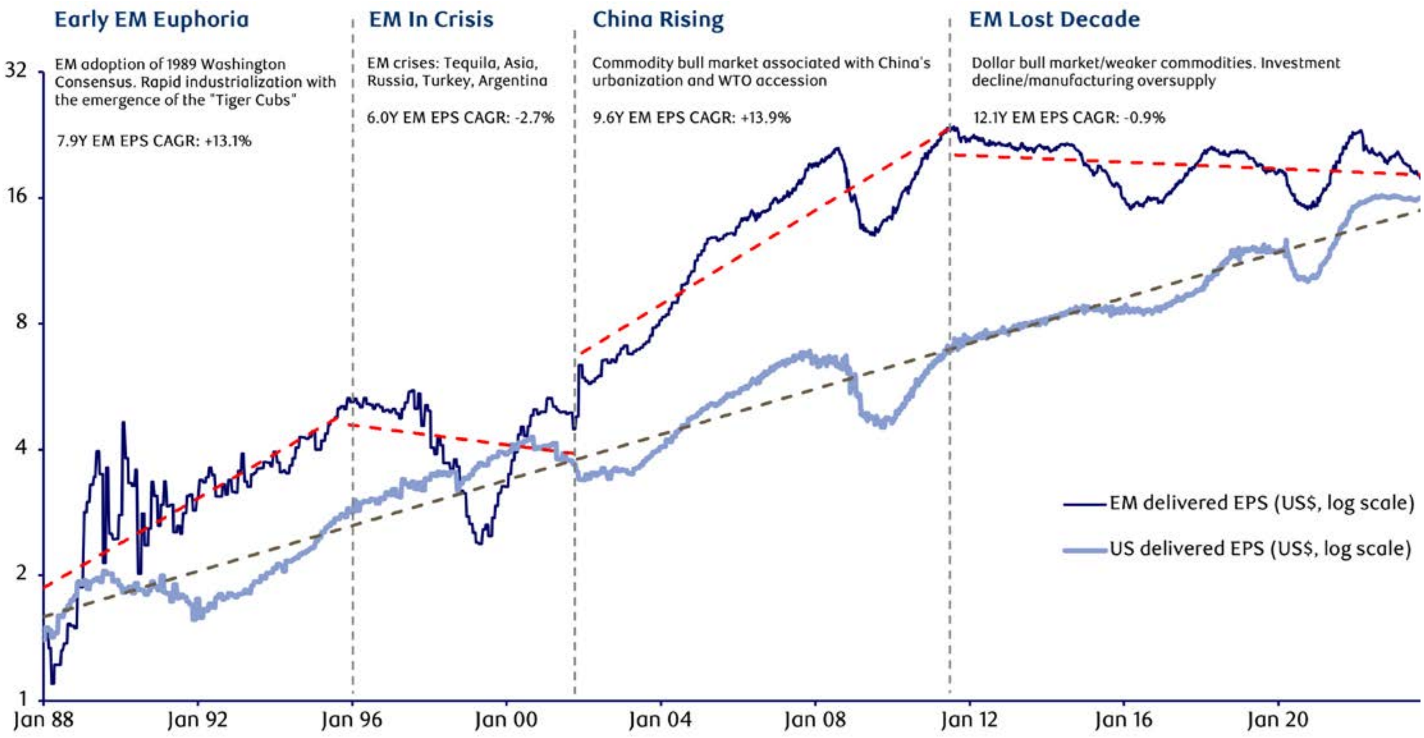


*Brazil, China, India, Indonesia, South Korea, Mexico, Malaysia, Philippines, Poland, Saudi Arabia, Thailand, Turkey, Taiwan, South Africa.
^Australia, European Union, Japan, United Kingdom, U.S.
Source: RBC GAM, CLSA, BIS, Refinitiv, MSCI, as of March 31, 2024.

Earnings

The last 12 years have seen broadly flat earnings growth among EM countries, in contrast to the decade before where earnings per share (EPS) grew broadly at a compound annual growth rate (CAGR) of 14% (see Figure 10). The key factor driving these earnings cycles is margins. Looking at margin cycles over long periods, they have a strong tendency to mean revert in all markets. Periods of strong margins attract capital, which leads to over-investment and a cycle of weaker performance.

Figure 10: EM vs US EPS since 1988 (USD, log scale)



Source: RBC GAM, CLSA, IBES, MSCI, as at October 2023.

Having come through a long cycle of weak margins, and with EM attracting relatively low levels of capital, we believe the outlook from here is positive. Lower interest rates and the potential for rates to continue to fall in many EM nations with high real rates should also support a recovery in margins. A further key factor will be the potential for a weaker USD to also be supportive of margin recovery.

Valuations

The sharp decline and performance of EM relative to DM equities has left the former looking very attractive from a relative-value perspective. For example, when looking at a price-to-book comparison in Figure 11, EM trades at a 45% discount to DM, which is close to its lowest level in 20 years.

Figure 11: MSCI EM Index relative price-to-book ratio

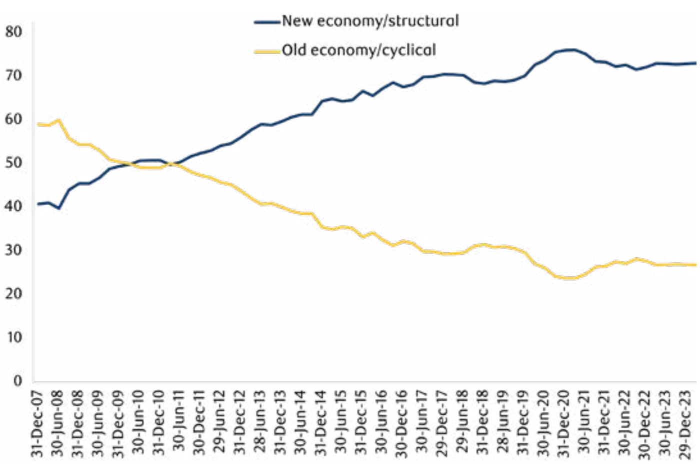
Source: RBC GAM, Bloomberg, MSCI, as at April 30, 2024.

Historically, we have also seen a close relationship between valuation and changes in return on equity (RoE), and EM equities have tended to have extended periods of outperformance and underperformance driven by changes in profitability. We have long believed that the main driver of RoE in the short to medium term is margins and, as explained in the earnings section above, we think these are likely to begin to break in favour of EM.

Enhanced diversification

Emerging market equities also offer diversification benefits, particularly for Canadian investors. This effect has been heightened by the MSCI EM Index's shift away from "old economy" and cyclical sectors offered in the Canadian market (i.e., Energy, Materials, Telecommunication, and Utilities) and towards "new economy" structural growth areas (i.e., Information Technology, Health Care, and the Consumer sectors), as shown in Figure 12. Looking ahead, the growth of artificial intelligence in particular looks set to benefit many emerging market economies, particularly given the importance of markets such as Taiwan and South Korea to global semi-conductor and related industry supply chains.

Figure 12: MSCI EM Index sector weights (%)



Source: RBC GAM, FactSet, MSCI, March 2024. Note: "New economy/structural" includes IT, Consumer Discretionary, Consumer Staples, Healthcare, Financials, and Media & Entertainment under Communication Services; "Old economy/cyclical" includes Energy, Materials, Industrials, Real Estate, Telecommunication Services under Communication Services, and Utilities.

Conclusion

Despite the disappointing relative performance of the MSCI EM Index over the past decade, many EM countries have outperformed over recent years, and many more are poised to do so in the years ahead. Some EM nations are benefitting from the new "China Plus One" model – most notably Mexico, India, and Southeast Asia – while others are beginning to reap the rewards of reforms implemented in recent years, particularly India and Indonesia. India's weight in the MSCI EM Index has doubled over the past five years, and it seems to be following a similar trajectory as China did in the early 2000s. Finally, South Korea and Taiwan are becoming major beneficiaries of the digitalization and AI themes, being home to a large part of the value chain.

Against this backdrop, we believe that superior growth from EM should accelerate, driven by urbanization and demographics, which we expect in turn can lead to a rapidly expanding consumer class. At a company level, valuations continue to look extremely attractive, with a number of key metrics appearing at or near historic lows.

For Canadian investors, EM equities also offer access to growing markets with strong demographics and greater exposure to high-growth sectors that our own market lacks. Ultimately, at a time when it is difficult to find attractive assets at reasonable valuation levels in DM equity markets, there is a strong case for investing in EME at this point in its cycle.

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